THE RIGHTS OF THE DEFRAUDED CUSTOMER OF AN INSOLVENT BROKER.

Perhaps the most that can be hoped for these comments is that they will form a gloss for the appropriate portions of Mr. Dos Passos' work.[1] That learned treatise presented all apparent points of discussion so well that the work of a subsequent writer on any portion of stock exchange law cannot be very original. But a fit excuse is afforded for the present discussion by certain decisions that have come from the Federal and New York courts after the last edition of Dos Passos on Stockbrokers had been published, and so too late for the valuable discussion which doubtless they would otherwise have received.

These late cases, it is believed, are important because they answer many questions whose solution, however foreshadowed in earlier decisions, and by the commentator already mentioned, yet till now had really remained open. And they are interesting because they relate to the stockbroker who has passed the portals of the insolvency courts trailing a record of dishonest dealings in his clients' property. The situation of any such defrauded customer is of much interest, practical as well as theoretical, because the volume of daily transactions in this kind of business is enormous, and the number of persons so engaged is legion. While all Exchange rules demand the strictest probity of its members in their doings, still not all brokers are members of an Exchange, and even of those that are necessarily some must fail to observe the letter or spirit of the law, with the result that many are propelled by a rising market into the hands of their creditors, with insufficient assets and bookkeeping entries in the place of trust property. It is with the right of a customer who had entrusted securities to such a broker, to reclaim them or their proceeds from the assets composing his bankrupt estate, that the decisions already mentioned are concerned.

To appreciate the value of these late cases, of course, the reader must have ready in mind the primary function which a stockbroker fills for his customer. Before proceeding to their analysis, therefore, it would be well to get before our eyes the position which a broker assumes when he executes his customer's order to buy a certain security.

---

[1]Dos Passos, Stockbrokers (2nd ed.).

There are two ways for one to purchase stock or bonds through a broker. The customer may give the broker the full amount of the requisite purchase price. Or he may make a margin arrangement with the broker; the usual margin required being ten per cent. of the purchase price. In such a transaction the customer pays the broker this margin; and it is then the duty of the broker to buy the stock, himself advancing the remainder of the necessary amount.

In either case the broker assumes a fiduciary relation towards his customer. If the customer gives the broker the full purchase price, then the broker assumes the duty of applying the money to the purchase of the stock. If he does not buy the required security he is guilty of embezzlement.[2]

Where the transaction is one of margin, the situation of the parties is equally well defined. On the London Stock Exchange, a contract for the purchase of stock is not immediately consummated, but remains open for some time, the settling days being at considerable intervals apart.

But on an American Stock Exchange, unless otherwise specially arranged, each contract of purchase contemplates performance within the following day. Consequently the ordinary buying order demands that the broker should have the stock in charge within twenty-four hours.

Then he must "carry" the stock until the customer orders him

[2]We need go no further for authority on this point than the recent case of People *v.* Meadows (1910) 199 N. Y. 1. There it was held that the broker's use of the money in his own business constituted embezzlement, because he had the money in trust for the particular purpose of buying the stock. The court said: "Of course, the moneys came lawfully into the defendant's possession and therein lies the distinction between the embezzlement, of which the defendant was guilty, and the common-law form of larceny; in which latter offense, the intent to misappropriate must have existed at the inception of the transaction in which the property was obtained. Where the offense consisted in the appropriation by an agent, a bailee, a trustee, or an attorney, of the property of the owner, the felonious intent need only exist at the time of the appropriation; for, in such a case, the property stolen would have been properly in possession of the defendant. (*People* vs. *Moore,* 37 Hun 84). The criminal act in this case was committed, and the criminal intent evidenced, when, departing from his duty to use the moneys in payment for the stock, the defendant diverted it to other purposes. * * * A deliberate diversion of the moneys being shown it required but slight evidence in the facts and circumstances to satisfy the jurors as to the existence of the felonious, or criminal intent. His expectation or intention, of restoring the moneys so diverted, of course, was of no avail. (Penal Code, section 549.)" *Ibid.* 6, 7. In short, as the court said in the same case: "Brokers are but agents for those who employ their services and the terms of the agency define and govern the nature and scope of the agent's powers." *Ibid.* 6.

either to sell it to someone else, or to give it to him. If the broker sells the stock to another, then from the purchase price he deducts the amount of his advance and turns over the remainder to his customer. Likewise the customer at any time may have the stock upon reimbursing the broker for the amount of his advance. If, however, pending the receipt of direction from his customer, the market price of the stock goes down, the broker has the right to require more margin, in order that, should the price fall below the original margin, he will be in no danger of losing any part of his own advance. If the customer refuses to give the additional margin called for, then the broker has the right to sell his stock in the open market, deducting from the proceeds of the sale the amount of his advance, and turning over the balance, if any, to the customer.[3]

In actual practice the broker does not advance out of his own pocket the money necessary to buy the stock. On the contrary, he hypothecates the purchased stock to a bank for the necessary amount. Hence, in every margin transaction there are three parties, the customer, the broker, and the broker's bank.

Concerning the relation of the broker to his margin customer there are conflicting views. The Massachusetts courts hold that the broker is the owner of the stock but has contracted to sell it to the customer, the stock being held by the broker as security for the unpaid purchase price. In other words, it is a conditional sale.[4] The New York rule, on the other hand, makes the relationship one of pledge. The broker buys the stock for the customer, and then the latter hypothecates it to the broker to secure the margin advanced him for its purchase.[5]

---

[3]It follows, therefore, that a sale of the stock by the broker without notice to the customer is a conversion. Content *v.* Banner (1906) 184 N. Y. 121.

[4]Wood *v.* Hayes (Mass. 1860) 15 Gray 375; Weston *v.* Jordan (1897) 168 Mass. 401.

[5]Markham *v.* Jaudon (1869) 41 N. Y. 235; Baker *v.* Drake (1876) 66 N. Y. 518. The Appellate Division has recently clearly stated this view as follows: "Undue prominence given to the fact that on the purchase of the stock the plaintiff advanced $5,000 and the defendants $40,000 results only in confusion of thought. When purchased the shares of stock became the plaintiff's property precisely the same as though he had advanced the whole purchase price. In fact he did advance the whole purchase price, borrowing for that purpose $40,000 of the defendants. The defendants took no risk of the speculation. They were at all times protected. If the margin became impaired by a decline in the market value of the shares, they could always sell upon notice to the plaintiff. I am unable to perceive how in principle there can be any distinction between a pledge of shares of stock to a broker as security for advances

In order to help the broker raise the money for the purchase of the stock, the New York courts go even further. They permit him to pledge in a common loan the stock purchased by him for customer A along with other securities purchased for customers B, C and D. They thus allow the broker the fullest use of all such securities in the way of raising the purchase money on them, subject only to the final rule that the broker is at any time liable for conversion, if he is unable to tender to his customer, when required, not necessarily the identical securities originally purchased, but similar shares of the same stock.[6]

Such is the New York rule, which has also been adopted in a number of other states, such as California, Illinois, Pennsylvania and Connecticut.[7] It is also the rule of the Federal Courts; their attitude on this question was finally settled some four years ago.[8] As the cases to be discussed all arose within the jurisdiction of either the New York or the Federal courts, their determination rests entirely upon this pledge doctrine and so as a pledgee the broker must be considered in all of the margin transactions that we shall now discuss.

When a broker conducting such a business fails, of course he should have on hand, or in pledge with the banks, enough securities of the kind ordered by his margin customers to meet their contracts with him. He should likewise have on hand, set apart from his own assets and free from lien, all moneys furnished him with which to buy securities outright, all securities so acquired for customers who have paid in full, and all securities which his customers have left with him, for safe keeping or otherwise, upon which he has made no advances. But many brokers in New York City have not obeyed the injunction of the law. Of course in the case of the mere "bucketing" of an order there is little to be said. There the customer's only recourse is to the criminal law. But recent failures of brokers in the City of New York have disclosed numerous instances of wrongdoing on their part, which have

made by him with which to make the purchase, and a pledge of stock or other property to a bank for an ordinary loan. The relation between the plaintiff and the defendants was that of debtor and creditor, pledgor and pledgee." McIntyre *v.* Whitney (N. Y. 1910) 139 App. Div. 557, 559.

[6]Lawrence *v.* Maxwell (1873) 53 N. Y. 19; Sprague *v.* Currie (N. Y. 1909) 133 App. Div. 18; In re McIntyre; Ex parte Niven (1909) 174 Fed. 627.

[7]See Richardson *v.* Shaw (1907) 209 U. S. 365.

[8]Richardson *v.* Shaw (1907) 209 U. S. 365.

proven even more troublesome to their defrauded customers and the courts than the outrageous practice of bucketing. The average of a number of recent failures has demonstrated that the bankrupt, while apparently purchasing in accordance with his customer's order, would actually, to use the language of Judge Hough, merely "go through the form of purchasing." An instance is in the case of *In re A. O. Brown & Co.; Ex parte Wilkin.*[9] There the customer ordered the bankrupt to purchase ten shares of American Locomotive. She was informed on the same day that the stock had been bought of another house and thereupon gave her check in full payment. But on the same day that the bankrupts ordered the stock to be bought, they ordered the same broker to sell another block of the same stock for other accounts. The bankrupt's broker made neither purchase nor sale. He simply offset the claimant's purchase against the other customer's sale and settled with the bankrupt for the difference, with the result that no actual physical delivery of stock was made. The bankrupt condoned this act, which undoubtedly was a gross wrong upon his customer.

In the same way, in the recent case of *Des Jardins* v. *Hotchkin,*[10] the defendants took buying orders from the plaintiff, their customer. But instead of buying the stock and retaining it for the customer's account, the defendants placed the order with another firm of brokers through whom, in turn, it was to be placed with an Exchange member. It did not appear that any of the orders were actually executed, but as the court said:

> "It would not have availed the defendants if they had been so executed, for it was the duty of the defendants to purchase and obtain possession of and hold the securities for the plaintiff, subject to their rights as brokers to pledge the same for advances in such manner that he could return them, and this they did not do."[11]

With such brokers the difficulty is undoubtedly their mental attitude. These men fail to realize that their duty is to execute their customer's order, and not to let the matter end in a book entry. Indeed at times lawyers have heard loose language to the effect that a street usage justifies such practices. It is needless to say, however, that no such usage, directly contrary to any legal

---

[9](1910) 185 Fed. 766, 767.

[10](N. Y. 1911) 142 App. Div. 845.

[11]*Ibid.* 847.

conception of the relation of broker and customer, can be sanctioned by a court.[12]

But it does not follow that because the broker has been guilty of a wrong the customer can be made whole. With a solvent broker that is so, and the cases are numerous where a customer has obtained appropriate relief.[13] But when the derelict broker is insolvent, a situation beset with difficulties is bound to arise.

Let us take first the case where the customer has paid the money in full with which to buy the stock. It is found, on the broker's failure, that the stock is not on hand. Undoubtedly the injured customer has a valid claim for money had and received. The stock for whose purchase he gave the money not having been delivered, the customer is entitled to have the money back.[14] Hence, as the broker is insolvent, the customers may file a proof of claim for the amount of money so entrusted to the broker.[15] Or, if the customer is already indebted to a broker on other transactions, he may if he pleases offset such a conversion against his indebtedness to the broker's estate.[16] If, on the other hand, the bankrupt has in fact purchased the stock, but later has sold it without the consent of the customer, the latter has a valid claim against the broker for conversion of the stock. In case of bankruptcy he is entitled under such circumstances to file a proof of claim against the estate for the value of the converted securities.[17]

---

[12]Many years ago an attempt was made to justify similar misconduct on the part of the house of Rothschild, but the House of Lords condemned it, Lord Wynford saying: "I am firmly persuaded that many bankers and many stockbrokers in London have acted precisely in the same manner as Mr. Rothschild acted on this occasion. * * * But it is enough to decide that the respondent had the right to say, I will not trust to the security of Mr. Rothschild or anybody else; I will have these bonds so that the King of Prussia may be security for my debt, and not Mr. Rothschild or any other proprietors of bonds. * * * Under these circumstances I repeat, that Mr. Rothschild has only on this occasion followed a practice which I believe has been acted upon in London. It is fit your Lordship should say now that such practices cannot be endured." Rothschild *v.* Brookman (1831) 5 Bligh, N. S. 165, 190, 195, 202. In the cases about to be mentioned the courts are likewise unanimous in rebuking all such shortcomings on the part of the broker.

[13]Recent cases are: Des Jardins *v.* Hotchkin (N. Y. 1911) 142 App. Div. 845; McIntyre *v.* Whitney (N. Y. 1910) 139 App. Div. 557, affirmed (1911) 201 N. Y. 526; Content *v.* Banner (1906) 184 N. Y. 121.

[14]Prout *v.* Chisolm (N. Y. 1895) 89 Hun 108, 21 App. Div. 54; Leach *v.* Haight (N. Y. 1898) 34 App. Div. 522; Lonergan *v.* Peck (1884) 136 Mass. 361.

[15]West *v.* McLaughlin (1908) 162 Fed. 124.

[16]Brown *v.* National Bank (1902) 112 Fed. 901.

[17]In re Brown; Ex parte Bank of Princeton (1910) 175 Fed. 769.

In all the cases so far discussed the measure of proof is the same. To make out a *prima facie* case of non-application of the customer's money, or of conversion of his securities, all the customer need prove is that at the time of the failure the securities which should have been purchased were not on hand, either at the broker's office or in any of the banks. This rule was established by the case of *Lonergan* v. *Peck*.[18] There in an action for money had and received it was held that the plaintiff sustained his burden of proof by showing merely that the broker at the time the action was brought did not have on hand or in the bank the security which he was ordered to purchase.

This decision was followed by the United States Circuit Court of Appeals, Sixth Circuit, in the case of a proof of claim against the bankrupt estate of the defaulting broker.[19] Of course no higher standard of proof is required from the margin customer. If it be found that the broker has not on hand, or in the banks, sufficient shares of the kind which he undertook to buy for the customer, then he is guilty of a breach of his undertaking. The practice in such a case permits the margin customer to file a proof of claim for the value of the stock on the day of the failure, less the amount which, on that day, had the broker then possessed the stock, would have been due him from the customer.

The doctrine of these cases, however, affords but cold comfort to the defrauded customer in the event of a heavy insolvency. It is all very well to allow him to file a proof of claim and prescribe the measure of the proof which will support it, but in the face of an estate which can only pay a few cents on the dollar or less, the claimant is not apt to be satisfied with a fraction of his stolen property. Consequently in the case of every such failure many a claimant seeks relief by another passage whose grades are sharp and whose pavement is indeed rough.

That road originated with the so-called doctrine of tracing trust funds, which sprang from the celebrated decision of the English Court of Appeal in the case of *In re Hallett's Estate*.[20] Prior to that case the rights of a person having an equity in specific property were of course clear. If the trustee for any reason deserved removal, or failed, or absconded, an Equity Court could take the property and give it to the *cestui*, or appoint another trustee. But if the trust property consisted of money, or if the

[18](1884) 136 Mass. 361.

[19]West *v.* McLaughlin (1908) 162 Fed. 124.

[20](1879) L. R. 13 Ch. D. 696.

trustee by his own wrongdoing had converted it into money, then the situation was different. The English judges at first took the metaphysical position that money had no earmark and was not capable of identification. Hence, if a trustee before his bankruptcy had converted the trust property into money, and mingled these funds in one bank account with his own, and perhaps as well the money of other beneficiaries whom he had likewise defrauded, the right of any beneficiary in the event of the trustee's insolvency to assert a claim on that fund was seriously disputed.

But the result of *In re Hallett's Estate*,[21] and the luminous judgment of Jessel, *M. R.*, there delivered, has resulted in the law, both in England and in this country, being, as the Supreme Court has stated, that:

> "* * * If money held by a person in a fiduciary character though not as trustee, has been paid by him to his account at his banker's, the person for whom he held the money can follow it, and has a charge on the balance in the banker's hands, although it was mixed with his own moneys * * *"[22]

Nor does it matter that the trustee, after mingling the funds, has made withdrawals therefrom. Prior to the case of *In re Hallett's Estate*,[23] it had been the rule that the various sums paid and repaid were set one against the other; so in effect the court would take it that the withdrawals were of the *cestui's* money, and not of the trustee's own money with which it had been mingled.[24]

But this was overruled by *In re Hallett's Estate*.[25] That case holds that where a trustee, wrongfully or otherwise, mingles his *cestui's* money with his own and then makes withdrawals from the mass so constituted, the court will presume that the money he withdraws is his own as distinct from that of his beneficiary, so that the balance remaining belongs to the beneficiary to the extent necessary to pay off his claim.

Consequently, if the broker appropriates his customer's money, or indeed, the proceeds from the unauthorized sale of the customer's securities, and puts them in his bank account, the customer may, under this trust fund theory, be entitled to the bank account itself.[26]

---

[21] *Supra.*

[22] National Bank *v.* Insurance Co. (1881) 104 U. S. 54, 68.

[23] *Supra.*

[24] Pennell *v.* Deffell (1853) 4 De G. M. & G. 372.

[25] *Supra.*

[26] In re Mulligan (1902) 116 Fed. 715.

Some of the recent decisions deal principally with this trust fund doctrine. They demonstrate a strong inclination on the part of the courts to limit its bounds. As the rule is clear and well established, however, this disposition can find vent only in regard to the proof required for the tracing. In other words, the difficulty nowadays is not in the invocation of the trust fund doctrine, but in the quality of proof required for a *prima facie* case. This is strikingly demonstrated by a decision in the A. O. Brown bankruptcy; *In re Brown; Ex parte Horrocks.*[27] The proof there offered was exactly the same as in the case of *West* v. *McLaughlin,*[28] to which we have referred. In each case the claimant gave the bankrupt money with which to purchase stock, and in each case the claimant proved that the stock was not on hand at the time of the failure. In *West* v. *McLaughlin,* it was held that this was sufficient to entitle the claimant to file a proof of claim against the bankrupt estate for the money had and received. In the *Horrocks Case,* on the contrary, the Circuit Court of Appeals, Second Circuit, held that, although the money was duly traced into a bank account yet this evidence did not entitle the claimant to claim his money under the trust fund theory. The distinction is thus stated by the court:

"The case of *West* v. *McLoughlin,* * * * on which the claimant relies, is not applicable, because in it no adverse claim of title was made. Of course, in a suit against Brown & Co. for breach of contract the claimant would make out a *prima facie* case by showing them that he had paid them for the stock and had not received it. The burden would then be on the defendant to explain. But, where he asserts a title to or lien upon funds in possession of an insolvent as against general creditors, he must go further and actually trace his property into the fund."[29]

At first sight this distinction would seem inexplicable. But fairness requires a further inquiry. The essence of the claimant's case was that the broker received the money for a certain purpose and did not so apply it. The money being identified in the bank account, it remained for the petitioner to show that the bankrupt did not acquire the stock. He might well have used his own money for its acquisition, in which event the petitioner would be entitled to the stock, and not the money in the bank. Therefore the petitioner had to sustain the burden of showing that the bank-

[27](1910) 185 Fed. 766.
[28](1908) 162 Fed. 124.
[29]In re Brown; Ex parte Horrocks (1910) 185 Fed. 766, 767.

rupt did not acquire the stock with other money of his own. If the bankrupt had acquired the stock, then if the stock were not on hand the petitioner's claim would be, not for the money which he had originally advanced, but for the proceeds of the converted stock. In other words, the tracing would be in a different direction; he would have to trace, not his original money, but the money which was received by the bankrupts from the sale of the stock.

This is clearly brought out in a previous decision of the same court.[30] In that case the claimant gave the bankrupt the money in full with which to purchase certain stock. The bankrupts bought the stock but immediately afterwards sold it again. The District Court held that the claimant, upon discovering that the stock had been converted, was in a position to rescind the entire transaction and reclaim his purchase money. The court, however, dismissed the claim, on the ground that the purchase money had not been traced. The Circuit Court of Appeals, while affirming the ultimate result reached by the District Court, disagreed with its views as to rescission. Noyes, *J.*, who deliverd the appellate court's opinion, clearly states the rights of the parties in the following language:

"While we approve the ultimate result reached by the District Judge, we think the ruling that the claimant had the right to rescind the whole transaction upon the conversion of its shares and follow the purchase price was erroneous. The right to rescind a contract and recover that which had been parted with under it does not exist in a case like the present. That specific right is available only in cases of fraud, undue influence, or duress.

"When the brokers, after purchasing the shares ordered and paid for by the claimant, wrongfully converted them, the claimant had an election of remedies:

"(1) It might have brought an action of tort for the conversion.

"(2) It might have waived the tort and sued for the proceeds of the shares—if in money—and also have followed such proceeds as a trust fund in the hands of the brokers or their bankrupt estate.

"(3) Assuming that it was the obligation of the brokers under their contract, not only to purchase the shares, but to deliver them, the claimant had the right to treat the conversion as a breach of contract and sue for damages.

"(4) Similarly, it had the right to treat the conversion as a discharge of the contract and sue in assumpsit upon the implied contract to refund the money paid.

"But in the last case—as in the others—the right of action originated when the conversion took place. Then for the first time there was an implied contract to repay the moneys advanced

[30]In re Brown; Ex parte Bank of Princeton (1910) 175 Fed. 769.

to purchase the shares. Nothing which had taken place was annulled. The claimant's money had been expended precisely in accordance with its directions. Any trust attaching thereto had been fulfilled. There was no money in the brokers' hands clothed with a trust after the stocks ordered had been bought and paid for. And if there was any such money after the conversion, it was the proceeds of the shares, and not the purchase price thereof.

"It follows, then, that while the claimant had a right of action in assumpsit—as well as other remedies—it had no right to follow the purchase price as a trust fund, and as its petition was based upon that theory it was properly dismissed."[31]

The same court applied this distinction in the *Horrocks Case*.[32] There, as we have said, the claimant gave the bankrupt money with which to purchase a certain stock. On the failure he found the money in the bank, but did not find the stock. While this would constitute sufficient proof for a claim for money had and received, it did not constitute sufficient proof for specific reclamation of the money in the bank.

Having this nicety in mind, that to trace the property you must first establish the point where you were wronged, whether in the non-purchase of the stock, or in its subsequent conversion after it had been purchased, we can the better understand the decision of the Circuit Court of Appeals on the Wilkin claim.[33] In that case the claimant ordered stock to be purchased and gave her check in full. The bankrupt, instead of purchasing the stock, ordered another broker to do so, but on the same day gave the broker a selling order for the same amount of stock. The result was that the sub-broker offset the sale against the purchase, so that as a net result the bankrupt did not receive any stock for the customer's account. The Circuit Court of Appeals held that:

"* * * The remedy of Mrs. Wilkin was to trace, not the purchase price, but the proceeds of her stock, if she can, into the hands of the trustee."[34]

And rightfully, of course, for the reasons already assigned.

Another interesting feature of this question of the measure of proof is presented by the Bamford claim in the *Ennis and Stoppani Case*.[35] There the claimant put up a stock margin with the bankrupt. That is, he opened a speculation account with the bank-

[31] In re Brown; Ex parte Bank of Princeton (1910) 175 Fed. 769, 770.

[32] *Supra.*

[33] In re Brown; Ex parte Wilkin (1911) 185 Fed. 766, 767.

[34] *Ibid.* 768.

[35] In re Ennis; Ex parte Bamford (1911) 187 Fed. 720.

rupt for purchase of stock on a margin basis, and as margin deposited with the bankrupt certain other securities. After the failure all these securities were traced, and the claimant sought to reclaim them. It appeared that the bankrupt had indeed purchased the stock, but immediately afterwards had sold it. The claimant introduced no proof other than that offered in *West* v. *McLaughlin*,[36] and *In re Brown; Ex parte Horrocks*,[37] but the same court which had dismissed the Horrocks claim, held that this proof was sufficient. It was plain that so long as the petitioner was indebted to the bankrupt, the latter had the right to hypothecate his margin stock to the bank; but the petitioner, to meet this, asserted that he ceased to be indebted at the moment when the bankrupts had converted the securities which he had ordered them to purchase, and thenceforth the bankrupts had no claim against him. His proof, therefore, which was the same as in the *Horrocks Case*, was for a different purpose. It was not to sustain his tracing of his property, but to rebut the claim of superiority which had been made by other claims. Upon this distinction the court held the proof sufficient. Noyes, *J.*, who delivered the judgment of the court, thus distinguished its previous decisions:

"In reaching the conclusion stated in the text, we fully adhere to our opinion expressed in Matter of McIntyre, 174 Fed. 627, 98 C. C. A. 381, that conversion of shares on a particular day is not established by entries in a stock record book showing that on such day the difference between deliveries and receipts of shares of a particular stock was less than the number of shares of such stock purchased for the claimant. As we pointed out, the bankrupts may have had under their control other shares not shown in the stockbook. But the present case is of an entirely different nature. The appellant is not seeking to follow the proceeds of converted 'long' stock. The trustee is endeavoring to justify the hypothecation of the appellant's securities. Moreover, the inference to be drawn from a failure without the shares to be delivered on account of purchases is very different from that to be drawn from the mere difference in balances upon a particular day in a particular book.

"With respect to the burden of proof: The question here is not one of an adverse claim of title. The appellant is not attempting, with respect to the speculative account, to show damages by conversion nor to follow property. The inquiry is simply whether the bankrupts fulfilled the obligations which they owed to the appellant, and the controlling principles are those of West v.

---

[36] *Supra.*

[37] *Supra.*

McLaughlin, 162 Fed. 124, 89 C. C. A. 124, where the Circuit Court of Appeals for the Sixth Circuit, in holding that the burden rested upon the trustee of a bankrupt stockbroker to account for money placed in the hands of the latter, said: 'An agent must execute with fidelity the duties of his trust. He must make true and accurate reports of what he does, and must render a true account of money intrusted to him for investment or disbursement.' The decision of this court in the Matter of Brown, 185 Fed. 766, handed down November 14, 1910, is in no way inconsistent with this conclusion."[38]

And lastly it must be remembered that to establish a case of conversion by the broker, you must show that you cannot find in the bankrupt's estate, however unidentified, any number of shares of the stock which had been ordered, sufficient to have met your order. This is because, as we have seen, the broker has the right to tender to his customer, not the specific securities originally bought, but any similar shares of the same issue. Thus in *In re McIntyre; Ex parte Nivin*,[39] the claimant failed because the only evidence which he put in to establish a conversion consisted of entries in the bankrupt's stock record book showing that on one particular day there was a difference of only five shares between the receipts and deliveries of stock of the kind which he had ordered. But the court held that that was not sufficient, Noyes, *J.*, saying:

"There is nothing to show that, if the claimant had demanded this stock on the day in question, he would not have received it. The entries do not show necessarily that the brokers did not have under their control sufficient shares to make delivery. They may, in regular course of business, have parted with the possession of as many shares as they received, and yet have retained subject to their absolute control in the possession of another sufficient stock to meet the claimant's demand. If they did this, there was no conversion."[40]

Another angle of the same proposition is seen in *In re McIntyre; Ex parte Grace*.[41] The claimant ordered the bankrupt to buy 200 shares of railroad stocks, giving them the purchase price in full. The bankrupts did buy the stock, but later converted it; the claimant's confidence in their integrity having made her let

[38]In re Ennis; Ex parte Bamford (1911) 187 Fed. 720, 724-725 note.

[39](1909) 174 Fed. 627.

[40]In re McIntyre; Ex parte Niven (1909) 174 Fed. 627, 628; so, too, with In re Ennis; Ex parte Lassen (1911) 187 Fed. 728.

[41](1911) 185 Fed. 96.

the stock remain in the bankrupt's custody. The money received from this wrongful sale of the stocks was traced, after the failure, into one of the bankrupt's bank accounts. So far as this account was concerned, it was held that the claimant had a lien upon the balance remaining at the time of the failure. But as many other claims were traced into this same fund through similar circumstances, the claimant's proportionate recovery would be very small. So the claimant endeavored to trace the proceeds of the conversion into the bankrupt's account in still another bank. The bankrupts, it seems, had borrowed money from this second bank. Just after they converted the claimant's stocks, depositing the proceeds in the first account, as already stated, the bankrupts put up with the second bank, as collateral for its loan, a certified check on the first account. The second bank collected this check, issued its own certificate of deposit for the proceeds to the bankrupts, and then held this certificate as collateral for the loan. After the failure, the second bank applied the certificate of deposit to the payment of its loan leaving a balance in the bankrupts' favor. It was held that the claimant had no lien upon his balance, the court saying that if there was any inference that the certified check represented the proceeds of the conversion, under the rule of *Hallett's Estate*, still it

"certainly lost all possibility of identification when the check was collected and a certificate of deposit substituted in its place, and when the certificate of deposit was canceled and the amount thereof credited upon the note."[42]

But in *In re Ennis; Ex parte Bamford*,[43] where, as we have seen, the question of conversion arose only collaterally, on the point whether the claimant was indebted to the bankrupt so as to make other equities in his stock equal with his own, the trustee claimed that the petitioner failed to show a conversion because there appeared on hand in the bankrupt estate small lots of the stock ordered, although not sufficient in amount to fill the petitioner's order. But the court held that this did not destroy his case, saying:

"The contention of the trustee that the holding at the time of the failure of small lots of stock, less in each instance—except in the case of U. S. Steel—than the amounts ordered and reported

[42]In re McIntyre; Ex parte Grace (1911) 185 Fed. 96, 98.

[43](1911) 187 Fed. 720.

as purchased for the appellant's account, may be regarded as a part performance of the bankrupt's obligation to purchase and hold, if well founded, does not materially change the situation nor relieve the bankrupt from the substantial charge of conversion."[44]

It is already apparent, from the cases just discussed, that a margin customer has little chance for a specific reclamation. He cannot reclaim his margin advances, because usually the broker does at least "go through the form of purchasing," and so, to that point, there has been no breach. He cannot claim any specific securities, because, as we have seen, the broker is not required to set apart specific securities for the account of each margin customer. All he need do is to have enough of that class on hand to satisfy his clients' orders; and when he has many clients, and is insolvent, their claims to any securities in the banks must necessarily be subordinated to the better equities of even the class B claimants. The nature of class B will presently be discussed. A claimant of the latter class at least can establish from the beginning his claim to specific securities, however he may have allowed the bankrupt to use them, whereas the margin customer never did have a share to which he could point as specifically his own. The margin customer, therefore, is a negligible factor in reclamation proceedings. His proper place is only as a general creditor, proving, as we have seen, for a conversion as of the day of the failure.

But although a claimant may have traced his trust property into a specific stock or bank account on hand at the time of the failure, yet there may be elements present which will prevent his enjoying the entire fruits of his success. Other people may have succeeded in tracing their property into the same *res*. The broker, as we have seen, may mingle various margin securities in a common mass upon which to raise money in order to make the purchases required. In other words, if on a given day a number of customers should leave stock with him as margin for their accounts, the broker may deposit all these stocks in one bank as collateral for one loan. The trouble in this class of cases arises from the fact that the broker will often mingle with these securities others which he has no right to pledge. It very often happens that when a stock has been purchased outright for a customer's account, the latter will leave it with the broker for safe keeping. Such stocks often find their way into the bank loan. Then again it will be the case that the customer's account shows no indebtedness to the broker by reason of a rise in the market,

[44]In re Ennis; Ex parte Bamford (1911) 187 Fed. 720, 724 note.

or because the broker has already converted the stocks which he was ordered to purchase, or indeed, has not made any purchase at all; and yet the stocks which originally had been deposited for the margin of such accounts will either find their way into loans, in utter disregard of the customer's rights, or the broker will let them remain in pledge when he should have withdrawn them.

The result is that at the time of the failure the bank will have on hand a medley of securities which have been wrongfully hypothecated by the bankrupt as security for a loan. Of course the bank's position in the matter is secure. It is innocent of the various claims to these securities. Nor is any claimant in a position to attack the bank, because by leaving with the broker his security endorsed in such shape that it may readily be negotiated, he is estopped from asserting as against the bank's lien, his right to the security.[45]

The bank, therefore, is at perfect liberty to sell such of the securities as it pleases to make good its loan. The remainder of the securities, together with any surplus moneys arising from the sale, the bank of course must turn over to the bankrupt estate. Then the various claims will be asserted to this residuum of securities and shares, and the conflict of equities will thereupon arise.

As a prerequisite to your having any equity at all in the fund or securities, you must trace your property on the lines above discussed. The conflict of equities then arises between the successful of the tracers. For instance, there will be a deficiency between the total amount of the claims and the total amount of securities and cash handed over by the bank. Who is to share in this deficiency, and who should be reimbursed ahead of others? There will also be the legal expense of the proceedings necesary to determine these rights. Who must help bear the burden of these expenses?

In answering these questions the practice has become common for the master or referee having charge of the matter to divide the claimants into two classes. A good description of this practice is given by Judge Noyes in a case before him:[46]

"The master awarded relief to two classes of claimants for securities or proceeds—class A and class B. The claimants placed in class A were held entitled, by reason of superior equities, to the specific restitution of their securities, or were awarded a lien on said surplus fund for the amount of the proceeds of their securities, without contribution, except for expenses. The fund was insuffi-

[45]McNeil *v.* Tenth National Bank (1871) 46 N. Y. 325.

[46]In re Ennis; Ex parte Bamford (1911) 187 Fed. 720.

cient to pay all claimants upon this basis, so that the claimants placed in class B in receiving less than their proportionate share of the fund, were said to contribute to the burden of the loan."[47]

In discussing these cases, therefore, it will be more convenient to use this language of classes. The great distinction between the two classes is thus stated by Judge Noyes in the most recent case: "that superior rights should be granted to claimants whose securities have been wrongfully hypothecated by the bankrupts over those whose securities have been rightfully pledged."[48]

The learned Judge elaborates this in the following way: "When a broker pledges as collateral to his loan at a bank securities left with him for safe-keeping or for sale, he is a wrongdoer from the outset, and while the bank may have the right to hold the securities, the claim of the owner, upon the satisfaction of the bank's demand, is of the highest equity. On the other hand, when a broker, acting under the authority conferred upon him by a customer, hypothecates his securities, the latter may, upon the adjustment of his account with the broker and the termination of the bank's demand, reclaim his securities; but, as he has no ground for complaining that his securities were pledged, his rights are clearly inferior to the owner whose securities were wrongfully hypothecated."[49]

That is the broad line of distinction, but in its application, as the learned Judge says: "Some flexibility is necessary."

The distinction is well illustrated by *In re McIntyre; Ex parte Pippey; Ex parte Hudson.*[50]

In the case of Pippey it appeared that he owned a certificate representing 18 shares of Pullman stock. He endorsed it in blank and delivered it to the broker as security for transactions thereafter to be had between them, but he gave them no authority to repledge the stock. Later transactions were had, but they were closed out with the broker owing Pippey. Thereafter the broker pledged the Pullman stock with the bank. It was held that that appellant was entitled to go into class A. The Court, through Lacombe, *J.*, said:

"By reason of the circumstances that when he left the certificate with the brokers it was duly endorsed with a transfer in blank executed by himself, he exposed himself to risk of losing his stock

[47]*Ibid.* 721. In some cases, *e. g.*, Skiff *v.* Stoddard (1893) 63 Conn. 198, a more elaborate analysis is made, but after all such a situation must finally reduce itself to the point above indicated.

[48]In re Ennis; Ex parte Bamford (1911) 187 Fed. 720, 722.

[49]In re Ennis; Ex parte Bamford (1911) 187 Fed. 720, 722.

[50](1910) 181 Fed. 955.

if the person to whom it was pledged, in good faith, for a valuable consideration, found it necessary to sell it in order to secure payment of his advances. That would be solely because Pippey would be estopped from asserting his title against the person who had parted with value on the faith of the transfer he had signed. But the pledgee has not found it necessary to sell the Pullman stock. It has repaid itself from other items of the pledged property. It no longer has any lien on such property. It can no longer avail of any doctrine of estoppel. Pippey's title to his stock is absolute. He is entitled to the certificate which represents the title."[51]

But in Hudson's case the court noted an important difference in the facts. Mrs. Hudson loaned the stock to the firm to use in its business. The result was she was placed in Class B. The court said that the stock

"cannot, therefore, be treated as 'stolen stock,' as in Pippey's Case, although, having survived all the risks to which her contract with the firm exposed it and been fully identified, it remained her stock, subject to such liens and obligations as have accrued against it with her consent. It should therefore contribute with the other securities similarly situated, sold and unsold, to the payment of the loans to secure which it was rightfully pledged."[52]

The basis of these cases is of course the well established doctrine of marshalling, by which, as the equities may require, the court can compel an indifferent party to resort to one rather than the other of two securities which he holds. This idea is excellently stated in the leading case of *Skiff* v. *Stoddard*,[53] but is even more succinctly expressed in a recent New York case, where, discussing the equities of one Mrs. Beach, as against those of two other claimants, the court said:

"in other words, it would have been the duty of the bank, had it been advised of the facts, to have sold the securities of the appellants Henck and Townsend before selling hers. This is what ought to have been done, and inasmuch as a court of equity will consider that done which should have been done, it will now direct that the stocks of Henck and Townsend be sold and the proceeds be turned over to her, in so far as it may be necessary to make good to her the loss which she sustained by the unauthorized sale of the 300 shares of the Steel stock."[54]

---

[51]*Ibid.* 958.

[52]*Ibid.* 959.

[53](1893) 63 Conn. 198.

[54]Matter of Mills (N. Y. 1908) 125 App. Div. 730, 733. Similar clear discussions of this rule will be found in Tompkins *v.* Morton Trust Co. (N. Y. 1904) 91 App. Div. 274, aff'd 181 N. Y. 578; In re Berry (1906) 16 Am. B. R. 564.

Judge Noyes has recently put the idea in another form:

"The principle involved may be stated in another way by saying that the claimants whose securities were hypothecated by the bankrupts without right may be subrogated to the rights of the bankrupts against other claimants."[55]

Whether in a given case the securities were rightfully in pledge or not is to be answered by the fundamental rules, already mentioned, which govern the relation of broker and customer. But while this is easy to say, it is by no means a simple matter to apply this rule to actual cases. Distinctions, fully as sharp as those illustrated in our consideration of the trust fund rule, are bound to become necessary. The future will doubtless bring forth many more, but one recent instance requires notice.

In the case of *In re Ennis; Ex parte Bamford*,[56] the bankrupts originally were justified in pledging the trust stock. The customer had directed the bankrupts to purchase a number of shares on margin. Instead of a cash margin the customer deposited with the bankrupts certain securities. The bankrupts promptly hypothecated these securities to a bank along with a mass of other securities. They then purchased the stock which was ordered, but soon thereafter sold it without the customer's consent. The customer on the failure claimed that he should be placed in class A because the bankrupt's only lawful reason for repledging his collateral was to secure what he might owe. While at the outset he did owe the bankrupts something, yet when they converted the purchased securities, he no longer owed them anything: it was then their duty to withdraw from the bank the customer's collateral because there was no longer any reason for its being hypothecated. Authority was afforded for this view by the language of the New York Court of Appeals:

"Conceding the right to use the stock pledged, by way of hypothecation, or otherwise, as claimed, and that it was at the time of the tender and demand lawfully out of the actual possession of the defendant, it was his duty at once to regain the possession and restore the same to the plaintiff."[57]

The Circuit Court of Appeals recognized the customer's right to be placed in class A, saying:

"That the bankrupts by the conversion of the appellant's 'long' securities and failures to carry them, lost their right to the con-

[55] In re Ennis; Ex parte Bamford (1911) 187 Fed. 720, 722 note.

[56] *Supra.*

[57] Lawrence *v.* Maxwell (1873) 53 N. Y. 19, 23.

tinued use of collateral deposited as margin on stocks to be actually carried.

"* * That for some time prior to the failure the bankrupts owed the appellant the duty of withdrawing the securities in question from the pledge in the Mechanics Bank and of surrendering them to him.

"* * That consequently the securities in the bank at the time of the failure stood * * in the position of securities wrongfully pledged."[58]

In Matter of Mills,[59] an apparently similar situation existed. Two claimants, Henck and Townsend, were indebted to the brokers, so the latter had the right to hold their stocks as security for the indebtedness, and, consequently to hypothecate them. But just before the failure Henck and Townsend each tendered to the brokers payment of the amounts owing by them and demanded the return of the securities held as collateral. The bankrupts refused this. Nevertheless it was held that these claimants belonged in class B.

The difference between that case and the *Bamford Case* appears to be this: Bamford ceased to be indebted to his brokers by reason of their wrongful act in converting his "long" stocks. Henck and Townsend, however, ceased to be indebted to the firm only through a tender of the amount owing by them.

It is hard to see a true distinction in this. The Federal Court of Appeals, indeed, being lately called upon to draw this very line, refused to do so, and held that a tender, such as was made in the *Mills Case,* discharged the customer's indebtedness to the broker, and entitled his claim to a place in class A.[60]

But however the courts may differ in the particular case, the judicial trend is uniform toward marking out the rights of all parties in these complicated modern instances by the use of a few simple principles of equity. In any such case one should first remind himself of the legal relation of broker to customer. Then must be applied the trust fund doctrine with due regard to the point at which the facts of the case force the tracing to begin. And lastly, if the tracing, properly begun and logically followed, should end in a fund or other specific *res,* and it is found that other claims, likewise traced, have converged upon the same point, the balance of the equities will be struck with the aid of the equity

[58] In re Ennis; Ex parte Bamford (1911) 187 Fed. 720.

[59] (N. Y. 1908) 125 App. Div. 730.

[60] In re McIntyre; Ex parte Loeser (1911) 189 Fed. 46.

doctrine of marshalling. There is some law perhaps yet to be made at this juncture, as the cases last discussed would suggest, although it is to be hoped that the practices condemned by the decisions above noted will hereafter not be quite so prevalent.

GARRARD GLENN.

NEW YORK.